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| In the Matter of | ) | |
| Federal-State Joint Board on Universal Service | ) | CC Docket No. 96-45 |

# COMMENTS OF AD HOC TELECOMMUNICATIONS USERS COMMITTEE


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# SUMMARY

The Ad Hoc Telecommunications Users Committee advocates a universal service support mechanism that is explicit, targeted, competitively neutral, and properly sized to support universal service and nothing more. The emergence of competition in local markets, as encouraged by the Telecommunications Act of 1996, depends on a universal service support mechanism that does not indemnify incumbent carriers for investments made in a monopoly environment or for reductions in revenues as a result of competition.

The core services identified by the Commission for universal service support reflect the Committee's position that the selection of such services be market-driven but targeted.

Under the new "regulatory bargain" evidenced in the 1996 Act, local carriers may enter new markets but may have to sacrifice the financial security that now-outmoded subsidy programs provided.

The use of a forward-looking cost proxy model is consistent with the objectives of the 1996 Act. In addition, revenue contributions from other LEC services, such as Yellow Pages advertising and other services linked to the provision of the dial-tone line, should be considered in determining support requirements.

The CCLC should be eliminated and recovery of present CCL revenues should be shifted to the SLC.

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To: The Commission

## COMMENTS

The Ad Hoc Telecommunications Users Committee (the "Ad Hoc Committee" or "Committee") hereby submits its comments in response to the Notice of Proposed Rulemaking and Order Establishing Joint Board, FCC 96-93, released March 8, 1996 ("NPRM").

## INTRODUCTION

The Ad Hoc Committee has consistently supported universal service funding in an economically efficient manner consistent with sound public finance principles. The Committee has a strong interest in encouraging the growth of competition in the local service market, and, in related proceedings, has taken the position that economically efficient pricing of telecommunications services is essential to the creation of an environment friendly to competition. In the long run, vigorous competition will be the most reliable source of economically efficient universal service funding. But a poorly circumscribed universal service support program will result in uneconomic pricing and retard the development of competition.

In these Comments, the Committee offers an analytical approach for restructuring the universal service support program in a more economically efficient manner that should stimulate competition and achieve the goals of universal service expressed by Congress in the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (the "1996 Act") through a rational balancing of competing policy objectives. Although the Committee lacks the data necessary to apply its proposed analytical approach, it encourages the Commission to apply that approach to data provided by other parties.

The Commission faces a daunting task in this proceeding -- nothing short of overhauling the existing universal service support mechanisms, as the Act requires and the Commission has acknowledged the need to do.[1] The key to sound public policy in this area is to properly balance competing objectives and to fashion a transition from the current inefficient universal service support system to one driven by vigorous competition and augmented by an explicit, properly targeted subsidy mechanism that is competitively neutral and appropriately sized to support universal service, but nothing more.

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[1] NPRM at ¶ 39; *see* S. CONF. REP. NO. 104-230, 104TH CONG., 2D SESS. 131 (1996) (cited in NPRM at note 85). Shielded from this overhaul is the Lifeline Assistance Program under Section 69.117 of the Commission's Rules, 47 C.F.R. § 69.117. The 1996 Act specifically provides that nothing in Section 254 of the Communications Act (the "Act") is to affect the "collection, distribution, or administration" of that program. 47 U.S.C. § 254(j); NPRM at ¶ 63.

## I. The Selection of Services to be Supported by Federal Universal Service Support Mechanisms Should Be Targeted and Market-Driven

The 1996 Act reflects Congressional intent that the Commission's definition of services to be supported by the universal service support program be market-driven. It requires that such services be those that, among other things, have been subscribed to by a majority of residential subscribers "through the operation of market forces."[2]

The 1996 Act also requires that the selection of supported services reflect those services that are being deployed by carriers,[3] another factor reflecting demand. Congress has recognized that the demand for services may change over time; thus, the Act explicitly acknowledges that "[u]niversal service is an evolving level of telecommunications services" and it requires the Commission to adjust the definition periodically as technology develops and demand for services changes.[4]

Congress's desire that support efforts be targeted and focused is demonstrated by the 1996 Act's requirements that support mechanisms be "specific" and that carriers receiving subsidies use them "only for the provision, maintenance, and upgrading of facilities and services for which the support is intended."[5] The 1996 Act also requires the Commission to consider "the extent

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2 47 U.S.C. § 254(c)(1)(B)).

3 47 U.S.C. § 254(c)(1)(C).

4 47 U.S.C. § 254(c)(1).

5 47 U.S.C. §§ 254(d), 254(e).

to which such services . . . are essential to education, public health, or public safety."[6] Thus, even if a "substantial majority" of American consumers subscribes to a particular service, such as call waiting, that service should not be eligible for universal service support if it is not "essential to education, public health, or public safety."

In determining which services satisfy the demand and public necessity tests for support eligibility, the Commission should consider only the realities of today's average residential subscriber, not the hypothetical subscriber of tomorrow. In this regard, the Commission's list of five "core" services potentially eligible for support[7] -- voice grade access to the public switched network, touch-tone dialing, single-party service, and access to emergency and operator services -- is generally representative of the services most households use and need today, and therefore satisfies the demand and necessity requirements of the Act.[8]

More advanced services should not be eligible for support -- at least not today -- because they are neither subscribed to by a significant enough portion of residential subscribers nor necessary for health, safety or education, as required by the guidelines in Section 254(c)(1)(A) of the Act. As technology improves and becomes more ubiquitous, the Commission can revisit its list of

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6 47 U.S.C. § 254(c)(1)(A).

7 NPRM at ¶ 16.

8 47 U.S.C. § 254(c)(1)(A), (B).

core services and include such services, such as Internet access, if then warranted; but today's market realities do not justify support of services other than the five core services the Commission has identified.

## II. Universal Service Funding Requirements Should Be Properly Sized and Targeted.

In the NPRM, the Commission has appropriately recognized that universal service policy in the post-1996 Telecommunications Act era is not entirely the same animal that it was under the Communications Act of 1934. For example, as the NPRM discusses in detail, the 1996 Act expresses clear objectives regarding "affordability" of services and the "comparability" of services and rates offered in rural and urban areas. The Commission correctly recognizes that these newly articulated objectives should not expand, and indeed should help focus, the primary purposes of universal service support for the general public, *i.e.*, to promote reasonably priced local service in high-cost areas (including rural and insular locations) and for low-income customers.

The Ad Hoc Committee urges the Commission and the Joint Board to maintain this narrow focus in the face of what may be strong appeals by some incumbent LECs to broaden universal service support to compensate them for revenue erosion they claim may result from emerging competition.

In proceedings before state PUCs and elsewhere, LECs have asserted that their subscriber outside plant and other elements of the embedded infrastructure were acquired to satisfy their franchise or carrier-of-last-resort obligations, and thus were sized based upon an expectation of continued monopoly provision of local services.[9] The LECs have argued that the loss of market share to competing local carriers will reduce occupancy/utilization of this embedded infrastructure and thus will make it more difficult for them to be assured of recovery of their investment, resulting in "stranded" investment (the implication being that such investment becomes effectively abandoned as an economic matter). As a policy matter, it is inappropriate in a competitive environment to permit the LECs to recover their embedded investments through the universal service support mechanism.

### A. Recovery of LECs' embedded investments, particularly through the universal service support fund, is inconsistent with the competitive neutrality objectives of the 1996 Act.

Any claims of entitlement to broad-scale recovery of embedded investments throughout the LECs' networks, rather than specifically for geographic areas with high-cost characteristics, must be soundly rejected. First, it can be demonstrated that, in economic terms, there is no "stranded investment." Even if the economic value of certain individual components of the LECs' infrastructure eventually falls below book value, the LECs' rate base assets, in aggregate, will continue to possess an economic value in excess of net book value, as shown by the steady growth in the market-to-book value

9. *See, e.g.*, Direct Testimony of A. J. Varner (BellSouth) in Florida PSC Docket 950696-TP, August 14, 1995, at 8-9 ("Basic local exchange service (the service which initially comprises universal service) makes use of virtually all facilities used by LECs in building and maintaining their networks....Virtually the entire network is required for both obligations." [referring to universal service and carrier of last resort]; *see also* Direct Testimony of Peter F. Martin (BellSouth) in Tennesse PSC Docket 95-02499, October 2, 1995, at 11 ("The incumbent LECs invested in substantial amounts of plant to meet their obligation to provide service....With the change to a competitive environment, the opportunity to recover this past investment is basically eliminated.")

ratios for each of the seven Regional Bell Holding Companies ("RBHCs") since divestiture.[10] The fact that the LECs and their shareholders have consistently been permitted to recover and earn a fair return on their investments demonstrates that any claimed "regulatory bargain" has been fully and indisputably satisfied.

Moreover, there is no reason for the LECs' competitors to indemnify the LECs for their past investment decisions. Any observed underutilization of LEC plant should not be assumed to result from the entry of competing carriers, rather than from other causes, *e.g.,* overbuilding by the LEC in support of its competitive strategies, or simply the misforecasting of its plant requirements.[11] The onset of local competition (to date, barely present) did not take the LECs by surprise, and should certainly have been reflected in LEC construction planning. Regulators can and should reasonably expect that LECs have adjusted their business plans and construction programs for the onset of competition, including the possibile loss of market share. In the long run, the avoided incremental costs attributable to market share losses should, if anything, equal or even exceed the loss of revenue for these services, and, thus, in the long run, there

10. *See* Data Appendix to these Comments at A-1, A-1.

11. *See* California PUC, D.83-12-025, 13 CPUC 2d 412, 479 (1993)(imposing an underutilization penalty on Pacific Bell after finding plant utilization inappropriately low). Loop plant utilization in Washington by Pacific Northwest Bell (now US West) declined from 69.9% in 1975 to only 60.8% in 1988. In a study undertaken for the Washington Utilities and Transportation Commission, Economics and Technology, Inc. linked this decline in utilitization to the LEC's decision to continue to deploy loop plant for *potential* Centrex business, long after it had experienced a precipitous drop in the demand for Centrex service. *See* Selwyn, Lee L., Patricia D. Kravtin, and Paul S. Keller, "An Analysis of Outside Plant Provisioning and Utilization Practices of US West in the State of Washington," March 1990. Attachment 8.

should be no net loss or earnings shortfall when services priced below cost (as the LECs often claim with respect to residential exchange service) are "lost" to competitors.

The case for allowing investment recovery and return as part of the "regulatory bargain" is particularly unavailing in the case of price cap LECs. In seeking price cap regulation, LECs embraced a regulatory regime which, they asserted, would allow them to invest without review of their expenditures, but also without any guarantee of recovering their investments. In seeking to replace rate-of-return regulation with price caps, the LECs frequently and specifically invoked the notion that competition required regulators to sever the link between LEC revenues and the earnings level allowed under rate-of-return regulation.[12] Having made this bargain, the price cap LECs should not now be permitted to resort to the abandoned principles of rate-of-return regulation as a safety net for their competitive losses. Thus, any arguments based on stranded investment are particularly uncompelling as to investments made by the LECs since 1991, when price caps were implemented by the Commission.[13]

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12. Under price caps or other incentive regulation, any linkage between rates and costs is, in principle, permanently severed. Whatever revenue requirement exists under the "going in" rates implicitly captures the revenue requirement associated with plant then in service. With an annual adjustment factor being applied to the "going in" embedded revenue requirement (and subsequently to each previously-adjusted year's rates), there is no place in the price cap scheme to recognize the presence or absence of any specific amount of stranded plant, and, thus, it has no direct effect upon the gross revenues earned by the LEC.

13. *In the Matter of Policy and Rules Concerning Rates for Dominant Carrers*, CC Docket 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990).

Another important reason why incumbent LECs should not be permitted to tap universal service funding mechanisms to compensate them for revenue losses resulting from competition is that any erosion of the incumbent monopoly provider's market share will be gradual, not rapid and disruptive, as the interstate long distance market has demonstrated. In fact, LEC local market share erosion is likely to occur far more slowly than that experienced by AT&T, since, among other reasons, a switch from the incumbent LEC to another facilities-based provider will require the physical installation of the new entrant's services at their homes or businesses. During the time that such competition will require to evolve, incumbent LECs have an ample opportunity to adjust their capital spending to accommodate the new market conditions.[14]

There is an even greater problem with any proposal to recover "stranded investment" through a mechanism that places the financial burden either exclusively or primarily on competitors, on the theory that they are, in some sense, the "cause" of the stranded investment "problem." The decision to permit competitive entry (and thereby to amend or even abrogate the "regulatory bargain") has been made by the public generally through its regulatory authorities, legislatures, and the courts, as strikingly illustrated by the 1996 Act.

14. During the period 1984-1994, annual Bell Operating Company gross plant additions — the amount of new capital assets acquired during each year — averaged about 10% of each BOC's total plant in service. Over a five-year time frame, a LEC will on average replace some 50% of its plant, an amount that is grossly in excess of even the most optimistic (or pessimistic, from the standpoint of the LECs) predictions of competitive inroads. See Data Appendix to these Comments at A-1 to A-9.

The LECs have fully participated (as much or more than any other interest group) in the public debate that has led to current federal telecommunications policies. Indeed, as a group, the LECs will benefit as much or more than other interest groups from the new procompetitive policies by, among other things, being permitted to enter previously closed markets and to operate under lighter federal regulation. The price for this new "regulatory bargain" is that the LECs are not guaranteed of fully recovering the cost of past investment decisions made under the old "regulatory bargain."[15]

This new regulatory bargain, however, is abundantly fair. Competition cannot reasonably be expected to develop if the incumbent is guaranteed by government mandate to be compensated for competitive losses. No other industry sanctions such coddling of monopolists at the expense of potential competitors.

As the Committee stated in a related proceeding,[16] reference to LECs' forward-looking costs, such as those developed by a cost proxy model, is consistent with the competitive neutrality objectives of the 1996 Act. Embedded costs incorporate past engineering and acquisition decisions that may have little present utility due to significant and never-ending changes in technology. They

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15 That Congress intended the LECs to forego some advantages of their former monopoly positions as a prerequisite to entering new markets is demonstrated by the LECs' new interconnection obligations under new Section 251 of the Act and the showing that the Bell Operating Companies ("BOCs") must make under Section 271 before they will be allowed to provide in-region interLATA service.

16. Comments of the Ad Hoc Telecommunications Users Committee in response to Notice of Proposed Rulemaking in CC Docket No. 80-286 (filed October 13, 1995) at 16-18.

also are distorted and bloated by capital investment decisions made under rate-of-return regulation,[17] and by the LECs' business strategies, which have not been directed at achieving universal residential exchange service penetration. By contrast, cost proxy models have the distinct advantage of modelling objective, forward-looking costs of supporting the universal service goal, assuming efficient engineering and design. Because a cost proxy model does not incorporate the costs of any one particular LEC, it should satisfy the statutory requirement for a competitively neutral gauge of universal service support requirements. The Ad Hoc Committee emphasizes, however, that a thorough and methodical analysis of the inputs and assumptions of a cost proxy tool must be undertaken before it is adopted, a task for which the Ad Hoc Committee lacks sufficient data.

### B. Determination of the universal service funding requirement must be targeted to supported programs.

As noted previously, the Ad Hoc Committee generally agrees that the core services tentatively identified by the Commission for universal service

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17. Under rate-of-return regulation (RORR), LECs were confronted with strong financial incentives to overinvest in their capital asset base, because (a) they were largely insulated from financial and business risks by the regulatory process itself, and (b) aggregate earnings were themselves a function of aggregate net investment. See Averch, Harvey and Johnson, Leland, "Behavior of the Firm under Regulatory Constraint," *American Economic Review*, Volume 52, No. 5, 1962. One of the often articulated goals of "incentive regulation" was to reduce or to eliminate altogether this so-called "A-J Effect" by severing the link between revenues and costs. California PUC, Consolidated Dockets Nos. I.87-11-033 *et. al* and A.87-01-002, *Re Alternative Regulatory Frameworks for Local Exchange Carriers*, Decision 89-10-031, October 12, 1989, 33 CPUC 2d 43, at 44; and In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, *Second Report and Order*, October 4, 1990, at 15. Since the future will be characterized by regulatory mechanisms that minimize the historic overcapitalization incentive (or perhaps eliminate it altogether through competition), reliance upon embedded costs introduces a serious distortion and exaggeration of the forward-looking costs of providing universal service.

support are consistent with today's average customer's telecommunications service usage. To ensure that universal service funding requirements are as targeted as the Act intends, the Commission must limit consideration of LECs' costs to those investments that directly support the provision of universal service. In measuring or modeling universal service costs by proxy, there are two significant cost components that should be specifically removed: (1) all costs not associated with or driven by the need to provide a single access line per residential household; and (2) costs related to advertising, marketing, and related functions.

There should be no dispute that a residential customer's second or additional access lines do not fall within the definition of universal service; they are necessary for neither public health nor safety and their use is largely discretionary, as their minimal subscription rate reflects. Nonetheless, in designing and constructing their outside plant (*i.e.*, feeder and distribution infrastructures), LECs have deployed considerably more capacity than is required to provide one line per household. It is imperative to identify the costs of additional lines and remove them from the aggregate cost of distribution plant to arrive at the economic cost of providing universal service.[18]

A second set of costs not properly attributable to universal service are those for advertising, sales, external relations, and similar functions not necessary for the provision of universal service. Except where income

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18. Moreover, where economies of scale are achieved by installing additional capacity, these economies of scale should accrue to the benefit of universal service.

limitations come directly into play, residential customers desire and will subscribe to basic telephone service without having to be "sold" on the product.

Of the two alternative cost factors submitted by the Joint Sponsors of the Benchmark Cost Model,[19] the higher cost factor (supported by the LEC sponsors) is based on embedded costs. This cost factor is flawed because many of the expenses included in the reported costs either do not support the provision of basic residential local exchange service or disproportionately support other services and/or customer classes. The Ad Hoc Committee agrees in principle with the lower cost factor (supported by MCI), which is based on forward-looking costs and eliminates these advertising, sales, and other similar costs not necessary to support the provision of universal service.

### C. The FCC must consider both sides of the equation: universal service support requirements cannot be determined on the basis of costs alone.

In determining the amount of support needed for universal service, whether on the federal or state level, it is critical to recognize that cost is only one side of the equation. To complete the equation, the Commission must also consider the total revenues available to support universal service. Incumbent LECs often propose that the rate charged for services defined as "universal service" be compared to the cost attributed to those services without considering

19. Annual Cost Factor #1 (31.6765%) is based on historical accounting data and total expense levels of Tier 1 LECs utilizing 1994 ARMIS Form 43-01. Annual Cost Factor #2 (22.97%) is based on the Hatfield/MCI (forward-looking cost) study approach and reflects limited expense categories and amounts. MCI Communications Inc., NYNEX Corporation, Sprint/United Management Co., and US West, Inc., *Benchmark Costing Model: A Joint Submission*, Copyright 1995, CC Docket No. 80-286 (September 12, 1995) ("Joint Submission") at 4.

the significant stream of revenues from several interrelated sources that support the LECs' provision of basic service. This stream of revenues includes (in addition to revenues from the dial-tone line and other universal service elements):

1. revenues from services -- primarily Yellow Pages publishing -- for which the incumbent LEC has a clear competitive advantage due to its historic franchise monopoly, which would not be affected by a customer's decision to take service from a competitive provider; and

2. revenues from services associated with the dial-tone line and frequently ordered by residential exchange service customers, which follow the customer and thus remain available to support affordable universal service provided by the customer's chosen provider, *e.g.*, local usage, access revenues.[20]

**1. It is appropriate for Yellow Pages revenues to support the universal service objective since much of the the value of Yellow Pages is derived from universal service.**

Yellow Pages directory revenues have long been used as a source of financial support for below-cost pricing of basic local exchange telephone service, principally (but not exclusively) the residential "dial tone" exchange access line. While the specific pricing of Yellow Pages listings and display advertisements is typically not subject to review or regulation, the net revenues from Yellow Pages are, in many jurisdictions, used to lower the LECs' intrastate

20. In addition to revenues falling in these categories, LECs also generate revenues from the sale of optional and discretionary services, and services not dependent on their provision of the dial tone line, which should be considered in determining the extent of a LEC's revenues under the value-added funding mechanism discussed *infra*, pp. 24-25.

revenue requirement.[21] While for many years there have been no significant legal barriers to competition in classified telephone advertising and directory services, no serious competition has ever developed, and Yellow Pages publishing remains essentially a monopoly business of incumbent LECs.

In recognition of the enormous amount of revenue (subsidy) that was contributed by Yellow Pages to support basic exchange access services, the BOCs at divestiture were permitted to retain the Yellow Pages business. The divestiture Court, in making this determination, expressly found that this large subsidy, on which incumbent LECs had come to rely, "would most likely continue if the [BOCs] were permitted to continue to publish the Yellow Pages."[22] As the Court predicted, many state jurisdictions still require that Yellow Pages revenues be used in this manner.[23] Nothing from divestiture to the present has changed the public policy basis for this requirement. Thus, ratepayers should continue to receive the indirect financial benefit of Yellow Pages revenues, and such benefit

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21. In some states, LECs have succeeded in removing yellow pages revenues altogether from their traditional support role, or in limiting the aggregate amount of such revenues that will be available for this purpose. Where this has occurred, there is less overall contribution available to support below-cost pricing of the universal service baseline, but this "problem" is of course of the LEC's own doing. Clearly, before new contribution burdens are imposed upon competing local carriers and others, LECs should be required to *re-include* their substantial yellow pages profits within the overall support funding mechanism.

22. *U.S. v. AT&T*, 552 F. Supp. 131, 193-194 (D.D.C. 1982).

23. In those states which do not, the change in policy has been driven by intensive pressure from the incumbent LECs themselves. The decision to forego this support and, in essence, move the money from the company's regulated "pocket" to its unregulated "pocket," should not now allow the LEC to ask its customers and competitors to replace this support.

should be used in particular as an explicit offset against any universal service funding requirement.[24]

There are compelling economic justifications for this policy as well: Yellow Pages advertisers pay primarily for access to the LECs' customer base; therefore, the value of the Yellow Pages directory to the incumbent LEC is directly related to the number of telephone subscribers in the coverage area. This value is derived directly from the incumbent's ubiquity, and is not diminished even if some individual subscribers elect to take their dial-tone service from a competing carrier. It is not uncommon for the value of such ubiquity to translate into support for the underlying service: Newspapers, magazines, and radio and television broadcasters rely on advertising revenues to subsidize their operations. Thus, since the value of, and revenues from, the incumbent LEC's Yellow Pages are the direct result of near universal local connectivity, it is both justifiable from a policy standpoint and economically reasonable to require the substantial profits from Yellow Pages advertising to be used in support of universal service.

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24. The amount of Yellow Pages revenues, expressed on a per-line basis, is not insubstantial. In a recent proceeding in Washington State, Staff calculated that US West's Yellow Pages revenues translate into a minimum credit of $4.27 per month for each residence line. Thomas L. Spinks (Staff), Direct Testimony in WUTC UT-95-0200 at 5. Net directory revenues in Massachusetts in 1992 were $103 million (NYNEX-MA Cost of Service Study, 12 months ended November 30, 1992) and there were approximately 2.3 million households in the state (Joint Submission of Benchmark Cost Model at II-147); thus the Yellow Pages revenues per household can be estimated at approximately $45.89 per year ($3.82 per month). Extrapolating to a national level from the lower Massachusetts figure yields a $4.2 billion source of revenue from local exchange carriers' Yellow Pages.

### 2. Revenues from other services linked to residential access lines should also be considered.

Unlike Yellow Pages revenues, which remain with the LEC regardless of a customer's choice of local service provider, other services, directly tied to the provision of the customer's dial-tone line, follow the customer when it changes providers. Subscribers do not buy just one rate element (*e.g.,* the voice grade access line); they also buy such services as touch tone, local usage (on a flat or measured basis), extended area calling services, directory assistance, and the contributory elements of access charges (*i.e.,* the interstate SLC and federal and state CCLCs). In so doing, they generate a revenue stream for the LEC or CLEC that provides these services along with the services that comprise universal service. Although rate design and marketing decisions determine which residential services are priced below, at, or substantially above cost, each customer purchases some package of services, and pays a total rate. Thus, when assessing whether any support is required, the Commission should account for the revenues from the entire package of services purchased by residential customers in connection with their purchase of the dial-tone line.

## D. Defining "affordability" is necessary to properly size any universal service subsidy requirement.

Another element of the universal service equation that the Commission should consider is the concept of "affordability." Before the Commission prescribes universal service support, it must determine whether rates for subsidized services could be increased without adversely affecting subscribership within targeted groups. The Ad Hoc Committee urges the

Commission to adopt a flexbile definition and/or benchmark for affordability that sets subsidized rates by specifically targeting the needs of those individuals or segments of the population that require assistance.

Because policy makers have for years perceived a need not to raise the price of local telephone service, basic telephone service has gradually become cheaper relative to inflation, while prices of other items in the typical household's core budget have risen at about the rate of inflation. An underlying basis for maintaining local telephone service rates is the belief that local telephone service is "essential." But telephone service rates have been regulated primarily because of the presence of monopoly conditions, *not* because telephone service is “essential.” Many other goods and services (*e.g.*, food, housing) recognized as "essential" -- and arguably ”more essential” than telephone service -- are priced at market rates that are not regulated. Persons who are unable to afford these essentials may be eligible for assistance (*e.g.*, food stamps), but the government does not mandate a lower price for everyone's bread. While the nation's universal service policy is designed to promote ubiquity of service, there is no evidence that penetration levels would be compromised by modest rate increases, or that the policy requires artificially holding down the rates for such services.

In setting an affordability threshold for purposes of establishing support requirements, the Commission should systematically examine several factors that indicate affordability. The average rate that customers nationwide pay for basic local exchange service should be viewed as setting the lower bound of affordability. The national average residential rate for unlimited local exchange service, including the subscriber line charge, is approximately $16.76.[25] The simple average of exchange rates, however, is somewhat misleading, because of the diverse range of monthly local exchange service rates and the geographic territory of local calling areas. The current nationwide averaged rate is also affected by the fact that some states have engaged in rate rebalancing and others have not.[26] If some national average "affordability" level is to be developed, it should focus not on varying tariff definitions of "local" service in different locations, but upon a defined basket of services that includes both access and usage within a defined geographic area. Thus, while the "national average" rate for local exchange access service is a reasonable starting point, it clearly understates the actual amounts being paid by customers to meet their basic telecommunications needs.

Subscribership (*i.e.,* penetration) rates are also an important measure of affordability, and should be considered. The highest rate paid by customers for local exchange service in an exchange that maintains subscribership levels

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25. FCC Monitoring Report, 1995, Table 5.7 (1993 Data).

26. For example, in response to a directive by the Massachusetts Department of Public Utilities in 1990, NYNEX gradually increased local exchange rates and decreased intraLATA toll charges in a series of revenue-neutral filings. Massachusetts Department of Public Utilities, D.P.U. 89-300, *NET*, June 29, 1990; see also, D.P.U. 91-30 (1991), D.P.U. 92-100 (1992), D.P.U. 93-125 (1993). In 1994, the DPU determined that: "There has been no statistically significant change in the Massachusetts telephone service penetration rates in the years 1989 to 1992. ... Thus we find that through 1992 the transition to cost-based rates has not negatively impacted universal service, and the current proposed increase is unlikely to have an adverse impact on universal service." D.P.U. 93-125, *NYNEX*, January 13, 1994 at 58 (footnote omitted). This rate rebalancing experience in Massachusetts can be instructive as policy makers define "affordability."

within a reasonable target range is a another good indicator of what customers can, in fact, afford to pay.

Finally, household income is a major factor of subscribership,[27] and the need, if any, for universal service support.[28] By focusing on these various and specific indicators, the Commission should be able to define a "benchmark" for affordability that targets subsidies specifically to those individuals or segments of the population with the highest costs and/or the greatest need.

## III. The Burden of Contributing to Universal Service Support Should Be Allocated on a Value-Added Basis.

In the NPRM, the Commission identified several approaches that have been used to fund federal regulatory initiatives: contributions based on gross (interstate) revenues, contributions based on (interstate) revenues net of payments to other carriers, and contributions based on per-line or per-minute units.[29] The Ad Hoc Committee agrees that service-specific funding mechanisms (particularly those such as the CCLC that recover per-line costs on a per-minute basis) can create economic distortions that can lead to inefficient

27. Common Carrier Bureau, Federal Communications Commission, "Preparation for Addressing Universal Service Issues: A Review of Current Interstate Support Mechanisms" (hereinafter, "FCC Universal Service White Paper"), February 23, 1996 at 15-16.

28. The foregoing discussion deals with the subject of "affordability" for the general population. The Commission has recognized that the challenges of increasing penetration among low-income customers require special attention and may require more than the simple rate subsidy presently available under the Lifeline program. The Ad Hoc Committee supports the Commission's proposal to take a multi-faceted approach to increasing subscribership among low-income customer populations. See, NPRM at paras. 50-56.

29 NPRM at ¶¶ 122-124.

choices among alternative service strategies (*e.g.*, the use of dedicated access rather than switched access), and among competing service providers (*e.g.*, selecting an inefficient service provider that is not required to make universal service contributions rather than a more efficient incumbent that is required to make such contributions and to recover their cost through its rates).[30]

In place of this approach, the Ad Hoc Committee advocates the use of a "value-added" funding mechanism, rather than an assessment based on unadjusted gross revenues. For this purpose, "value added" would be defined as a provider's total gross common carrier service revenues minus payments made to other telecommunications common carriers for services that are themselves included within the aggregate "value added" funding base.

The method Ad Hoc proposes would first establish a total universal service funding "budget," which would then be divided by the total industry-wide "value added" product to produce a "burden rate." That burden rate would, in turn, be applied to each industry participant on the basis of its respective value added.

Assessing common carriers based on their value added, rather than on their gross revenues, would result in each telecommunications dollar being "taxed" only once. Otherwise (*i.e.*, under a gross revenues method), "downstream" providers would be unfairly required to contribute based on both

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[30] See NPRM at para. 57.

their own retained revenues and the amounts charged them by other telecommunications common carriers.[31]

## IV. The CCLC Should Be Eliminated, and Responsibility for Recovery of Present CCL Revenues Should Be Shifted to the SLC.

The Commission has requested comment on revising the universal service funding mechanism for recovery of the approximately 25 percent of unseparated subscriber line costs, a portion of which is presently recovered through flat monthly subscriber line charges (SLCs), with the remainder being recovered through a per-minute carrier common line (CCL) charge paid by IXCs and, ultimately, by subscribers in the form of higher interstate long distance rates.

The Commission has long recognized that the fairest and most efficient way to recover non-traffic-sensitive costs associated with the subscriber's access line is through a flat, usage-insensitive charge. The Ad Hoc Committee agrees with Commission that the per-minute CCLC is inconsistent with the policy guidelines of the 1996 Act, which require federal support to be explicit and provider-neutral.

The SLC caps presently in effect ($3.50 on residential and single-line business customers, $6 per line for multi-line businesses) were adopted in 1985, and those rates have been at their maximum allowed levels since 1989. In

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31. The Commission's formula for assessing regulatory fees (gross interstate revenues net of patments to other telecommunications carriers) was intended to avoid such "double taxation." *Regulatory Fees Order*, 10 FCC Rcd 13512 (1995) (cited at NPRM, ¶ 123 & note 260).